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TAGS: EFIN ECON RS
SUBJECT: RUSSIAN CENTRAL BANK ENDS GRADUAL RUBLE DEVALUATION

REF: (2008) MOSCOW 3582

Classified By: Acting DCM Eric T. Schultz, Reasons 1.4 (b/d).

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Summary
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¶1. (C) In a post-trading day press conference on January 22, Central Bank (CBR) Chairman Sergei Ignatiyev announced the end of the CBR's policy of gradual ruble devaluation. The announcement came two months after the CBR embarked on a series of 1-percent devaluations against a currency "basket" composed of U.S. dollars and euros. The devaluations had accelerated in recent weeks to practically daily occurrences as the CBR sought to realize a stable rate for the ruble. As part of the announcement, Ignatiyev said the CBR had also set a new lower limit for the ruble-basket exchange rate at 41:1, 10 percent below the current level, and would now move to a managed float. Ignatiyev said that absent further deterioration in the price of oil, the new limit was defensible and would help preserve remaining GOR foreign exchange reserves, which he acknowledged had dropped below $400 billion for the first time since 2004.

¶2. (C) Many analysts in Moscow welcomed the announcement as a step in the right direction; one that signaled the possibility for resumption of more normal economic activity. However, others argued that the CBR may have only bought themselves a few weeks with this latest move and that the ruble was likely to come under pressure again in the near future absent an uptick in commodity prices. End Summary.

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The End of Managed Devaluation
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¶3. (C) At the end of the January 22 currency trading session on the Moscow Interbank Currency Exchange (MICEX), CBR Chairman Ignatiyev announced that the CBR was ending its "managed devaluation" of the ruble and was moving to a managed float. He set a new upper limit of RUR 41 (roughly RUR 36 to the dollar at current euro/dollar exchange rates) to a basket composed of U.S. dollars (USD 0.55) and euros (EUR 0.45). The announcement came after more than two months of Central Bank interventions to facilitate a gradual decline in the value of the ruble. Starting in November 2008, the CBR initiated a series of 1-percent devaluations of the ruble (reftel), at first weekly, then several times a week, and in the last few weeks practically daily. These devaluations took the ruble-dollar rate from roughly 27:1 to 33:1.

¶4. (C) In making the January 22 announcement, Ignatiyev

argued that this "soft landing" policy had successfully avoided a 1998-style panic that might have ensued from a rapid fall in the value of the ruble while acknowledging that factors such as declining oil prices had driven ruble demand lower. However, he also acknowledged the cost of the policy, noting that reserves had fallen below $400 billion for the first time since 2004; a $200 billion drop from their peak in August. Ignatiyev indicated that until the ruble reached the new limit of RUR 41 to the basket, the CBR would not expend any of its remaining reserves in support of the ruble.

¶5. (C) Ignatiyev indicated, however, that some conditions could alter the CBR's plans. For example, he said that if the price of Urals were to fall to USD 37-38 from its current price in the low USD 40s, the ruble might not need support from the CBR. A sharp and sustained drop to USD 30 per barrel, however, would likely prompt the CBR to reconsider the ruble's upper limit rather than trying to defend it with reserves.

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Observers Cautiously Optimistic
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¶6. (C) Troika Dialog Chief Economist Evgeniy Gavrilenkov told us after the announcement that he thought the CBR was making a more rational step in the right direction. During an earlier meeting on January 22, he was visibly agitated in describing his frustration with senior GOR officials' management of reserves and the ruble. He said, for instance, First Deputy Prime Minister Shuvalov had sought the advice of a number of financial sector professionals "but ignored all of it." He was particularly upset at recent developments, where the GOR had accelerated the devaluations, correctly in his view, but then had intervened spending $30 billion in reserves earlier this week to defend the ruble.

¶7. (C) Gavrilenkov had argued to us in the earlier meeting that the sooner the GOR completed the devaluation, the sooner the Russian economy would begin to grow again. For much of the last two months, banks had essentially suspended their lending operations while they engaged in currency speculation, betting on the ruble's continuing slide. As a result, firms had little access to affordable credit and fell behind in paying wages and taxes. Many firms had also curtailed production during the period and used their cash for currency speculation.

¶8. (C) In that regard, Gavrilenkov said the CBR's new upper limit was probably close to equilibrium and should provide needed stability and reduce speculation. Oil prices in the low USD 40s were last seen in 2004, according to Gavrilenkov, and adjusting for inflation his calculation was that the ruble's equilibrium rate against the euro/dollar basket was RUR 42. Gavrilenkov said a stable, lower exchange rate could unlock import substitution and maintain a positive current account. However, he acknowledged that Russia's terms of trade would probably not improve until 2010 since the country would not be able to produce many of the imported goods, such as food and clothing that the appreciating ruble had previously made affordable.

¶9. (C) Gavrilenkov also echoed Ignatiyev's viewpoint on the significance of the price of oil. He said that if oil prices stabilize at current levels, then the CBR would probably have a few months before it needed to intervene again in currency markets. However, if oil prices fell further, the ruble would immediately come under renewed pressure and the CBR would have to decide how aggressively to defend the new limits.

¶10. (C) Deutsche Bank Chief Economist Yaroslav Lissovolik also told us he was pleased with the CBR's announcement. He said he thought the new limit was realistic and would make currency speculation against the ruble a much less attractive option. Lissovolik added that the CBR had timed its announcement carefully. Ruble liquidity was tight, given that tax payments were due earlier this week. In addition,

the GOR had used "communications" policy to tamp down speculation against the ruble, with Shuvalov and others making phone calls to a number of Russian banks to warn them against further speculation. Lissovolik also thought that the ruble policy would both preserve reserves and help restore the flow of credit to pre-crisis levels, which would help the Russian economy better adjust to new realities.

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Comment
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¶11. (C) The CBR's decision does not come as a surprise. It has been clear for some time that the GOR hoped to get close to an equilibrium point through the small devaluations and then planned do a one-off devaluation to get the rest of the way -- all without inducing panic. That said, it seems like a gamble. The GOR's bet is that oil prices will stabilize or rise and that currency speculators will look elsewhere. They may not. Other local analysts, including UralSib's Chris Weafer, are less sanguine than Lissovolik and Gavrilenkov, arguing that the GOR has bought itself only a few weeks with this announcement and that absent stronger commodity prices, the ruble has farther to fall and could soon come under renewed pressure. The policy has also been expensive, not just in reserves spent but in economic activity inhibited. Moreover, it has damaged the GOR's reputation. As one press article noted this week, two months ago senior GOR officials dismissed the possibility of devaluation -- anyone who took them at their word has seen the value of their ruble holdings decline by nearly a third in that time.
BEYRLE